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# VARIABLE ANNUITIES

## WHAT THEY ARE AND HOW THEY CAN BE USED BY ATTORNEYS

George E. Johnson*

### ORIGIN

Life annuities are as old as the dawn of history. They were used in financial transactions by the Assyrians and Babylonians before the birth of Christ.

In Roman days, there were problems of valuing life annuities in an estate. In the *Lex Falcidia* which was compiled about 40 B.C., the heirs of an estate were entitled to receive at least one fourth of the inheritance. As in current days, the will was sometimes made when the testator was in much better financial circumstances than at the time of his death. It then became necessary to reduce proportionately the value of the legacies. When the testator had provided for a life annuity to be payable to one or more legatees, questions often arose as to how the annuity should be valued. The Romans were skillful mathematicians and were clever at finance. They understood that a life annuity would be valued differently depending upon the age of the annuitant, and they understood that a proper mathematical basis was necessary to capitalize the present value of the annuities at a certain value.

In Kopf's discussion of early annuities, the author states the table of Ulpian attributed to the Prefect Ulpianus (225 A.D.).[1] Kopf states that diligent inquiry has been made to establish whether the values shown are those of the "expectation of life" or "the value of an annuity of one per year." This dispute has never been settled. If this table represents a valuation of annuities by using the value of an annuity of one per year, then the method is in all essentials the same as the method which we use today to value a life annuity, *e.g.*, an income to a life tenant.

### DEFINITIONS

The most frequently cited definition of an annuity is that of Lord Coke, who defined it as "a yearly payment of a certaine summe of

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1 Kopf, *The Early History of the Annuity*, in XIII PROCEEDINGS OF THE CASUALTY ACTUARIAL SOCIETY 225, 231-33 (1927).

money granted to another in fee for life or yeares, charging the person of the grantor onely."[2] Blackstone defined it as "a yearly sum chargeable only upon the person of the grantor."[3] Many American courts have referred to these definitions.[4] In recent years there has been a broadening of the definition in several respects. Annuities need no longer be paid annually, although they are paid periodically. Frequently, the payments are made monthly, quarterly, or semi-annually. One writer has said: "In a strict sense, the word *annuity* infers the interval of payment is one year, but by general usage its meaning has been extended to include other exact recurring intervals of time, such as six months, three months, or one month."[5]

At one time, the distinction between an annuity and a rent charge was considered important, but this distinction is no longer relevant. The agreement to make periodic payments which were charged not only against the person but also against land was first termed a rent charge.[6] For example, in *Routt v. Newman*,[7] the Court utilized Coke's definition and added the following: "It is used in a broader sense to designate a fixed sum payable periodically . . . and it may be charged on real estate as well as on the person."[8]

Without further elaboration of the legal definitions, reference should be made to another distinction which will be helpful to attorneys. Legal decisions often relate to the source of the annuity without such fact being mentioned in the report. The court is considering the fact situation in the particular case at hand, and not always looking at the whole spectrum of annuities. Thus, it is important to determine whether the annuities you are considering and the one the court is discussing are provided by Government, by life insurance companies, by a non-insured pension trust, through a private business contract, from an educational institution, or as the result of a life care plan. Hereafter, in this article, we will be referring primarily to annuities sold by life insurance companies.

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2 E. COKE, INSTITUTES OF THE LAW OF ENGLAND 1446 (1st Am. ed. F. Hargrave & C. Butler 1853).

3 2 BLACKSTONE, COMMENTARIES 40.

4 Bodine v. Commissioner, 103 F.2d 982 (3d Cir. 1939); Bartlett v. Slater, 53 Conn. 102, 107, 22 A. 678, 679 (1885); Bacon v. Comm'r of Corps & Taxation, 266 Mass. 547, 549, 165 N.E. 664, 665 (1929); Dwight v. Harris, 389 Pa. 520, 525, 134 A.2d 45, 48 (1957).

5 C. CROBAUGH, ANNUITIES AND THEIR USES 25 (1933).

6 *See e.g.*, Bartos v. Skleba, 107 Neb. 293, 185 N.W. 1002 (1921); 3 C.J.S. *Annuities* § 1(b) (3) (1936).

7 253 Ill. 185, 97 N.E. 208 (1911).

8 *Id.* at 188, 97 N.E. at 209.

## DEFERRED AND IMMEDIATE ANNUITIES

Annuities sold by life insurance companies to individuals may be either deferred or immediate annuities. In the case of a deferred annuity, sometimes called a retirement annuity, there is a period from the date the contract is issued to the date when annuity payments begin. For example, a man who is 50 may purchase a contract providing that annuity payments begin at age 65. Another man may purchase an annuity providing that annuity payments shall begin immediately after the contract is purchased. For example, a man who is 68 may purchase an immediate annuity with a single sum which provides that the first monthly payment will commence one month from the date of the contract.

## THE BASIC CONCEPT OF A DEFERRED ANNUITY

One day, everyone hopes to retire. Maybe this will be soon, maybe in many years. But in either event, a day will arrive when the man seeking retirement will be face to face with the same problem that confronts everyone who retires—finances.

Finances are the key. Finances usually determine when to quit work, where to live, what to do. One can find the right answers to these questions with foresight, but one cannot make these answers stick without the financing. Travel, fishing trips, gardens, and just plain living all cost money.

Moreover, finances are a problem for the wealthy and the non-wealthy alike. The first problem is to amass the money. Once the money or property has been amassed, the problem is half solved, but it is not wholly solved.

What else does one need when he retires? He needs an adequate income as long as he lives!

In short, during a person's working years, one needs to store up sufficient capital to provide him with an adequate life income when he is no longer working.

## THE STORAGE PROBLEM

First one must consider all of the resources that he will be relying on to replace his salary when leisure life begins. Such resources may include Social Security, a company pension, life insurance, a paid-for home, and the fruit of such investments as he is making now. Any and all of these factors affect the storage problem.

One of the best proven methods which has been widely used has been to set aside on a regular basis a certain amount payable to a life insurance company to purchase a deferred annuity. The company deducts a certain amount from these payments and invests the balance with the result that capital is gradually accrued. The semi-compulsion of having made a definite commitment to pay these regular stipulated payments and the regular receipt of the notices from the insurance company stiffens resolve and helps solve the storage problem.

By the time one retires he will have succeeded in amassing a capital fund. Now some method of transforming that capital fund into a roughly-regular monthly, quarterly, or annual income must be utilized. That method should also provide income more or less automatically, with a minimum amount of management.

A capital fund can be turned into income in one or two ways. One can invest in such a way that income is produced through periodic interest payments, dividends, or rentals. Or one can set up a system for the planned orderly withdrawal of capital at approximately regular intervals.

## "AN INCOME FOR LIFE"

Not knowing how long one will live presents the next dilemma. Let us see what a man preparing to live during retirement on a limited amount of money is up against.

At age 65, a man's life expectancy is about 16 years. But a life expectancy is merely an arithmetic average of the number of years that people have lived beyond a certain attained age. The 16-year figure is the average of all of those age 65 lifetimes.

Perhaps he will be one of those who will not achieve the average. In fact, very few men will. Perhaps he will be one of those who live for 30 years after retirement. Some men do.

Suppose, then, to make sure that he will not run out of money during his lifetime, he resolves to keep his capital fund intact, and live only from the earnings.

This may work if he is wealthy. But, unless he has plenty of money or needs only a very small income, he may have to take some long chances with the capital sum he has saved for retirement in attempt to get an adequate income.

If he invests the money and simply lives off the income, he can be sure that he will not outlive his income even though he lives for 30 years or more. In this case, however, his income is limited to the return on the capital. He will get no use from the capital itself, but he will have it intact when he is 95 years old. This may be fine for some remote beneficiary surviving his 95th birth date, but it has not been used in the form of retirement income payments to him.

Suppose, on the other hand, he decides to use both his capital and the earnings over a period of about 16 years—just about his life expectancy.

This will work well if he lives out his exact life expectancy. To be sure, he may have a few scary last years watching his capital dwindle away. He would enter his 16th year with no more than enough income for one year to his name. His life expectancy at that point, as an 81-year old man, is about six more years. This is not exactly a comfortable prospect. If he lives beyond age 81, his assets will be gone.

Fortunately, there is a way to cut through this dilemma—a way of using up both earnings and capital month-by-month, year-by-year, and yet being assured that one will not run out of money as long as one lives—as long as one needs an income.

The way is to buy a life annuity.

Life annuities are sold by life insurance companies. Where life insurance protects against dying too soon, life annuities protect against living too long.

Through the life annuity contract, the company agrees in exchange for money, to pay a certain income for life. Under an ordinary "straight life annuity" that is all it promises. All payments stop at death, no matter how soon or how long that may be.

If a little extra is invested, the company will promise a little extra. It will promise to pay a certain minimum number of income installments, continuing them to a beneficiary if the annuitant does not live to collect income for at least the assured minimum period.

The annuitant can also pay a little extra and buy an annuity which will continue until the death of the last survivor of him and his wife. In this way, he can be assured that the income will not cease while either of them live.

Note that the life annuity does involve some risk. The annuitant may die after collecting less aggregate income than he paid in as money to purchase the benefit. On the other hand, he may reap a fabulous return by living far beyond the average allotment of years.

This gamble is the thing that makes life annuities possible and practicable. No one can predict how long an individual will live, but mathematicians can predict how long a large group of people of the same age and sex will live on the average—how many will live one year, how many two years, and so on. A life insurance company can, therefore, calculate how much money it will need to collect in order to pay incomes to the entire group over their aggregate lifetimes. In effect, the money of those who die early is used to supply the longer-than average income to those who continue to live on.

If a life annuity involves this kind of a risk, though, it eliminates the other much more dangerous kind. It assures the annuitant that he cannot outlive his income. It eliminates the risk of outliving his capital. The owner of an annuity is assured of an income for life no matter how long it may turn out to be. The money paid the life insurance company is invested and the income guaranteed is drawn from both principal and earnings. What is most important is that the income duration is keyed directly to the need for an income which is of an equal duration.

## THE CONCEPT OF A VARIABLE ANNUITY

The fixed annuity, as described, is acceptable as far as it goes. But, there are two more hurdles: (1) inflation, and (2) the rising standard of living. A key objective of the variable annuity is to overcome these two hurdles.

### INFLATION

When an annuitant gets a life income with a steady stream of a fixed number of dollars, he knows that these dollars are a means to an end, not the end itself. They must be converted into food, clothing, rent payments, cancelation of doctors' bills, etc. If the cost of these expenses increases because of a rising cost of living, the dollars which he receives will purchase less in terms of what the economist calls "real income"—which measures the purchasing power of the dollar. For many years, this country has seen a steady inflation in the cost of living. For a long period of time this has averaged about 3% per year. This persistent inflation has meant that the value of life annuity income in terms of goods and services has been depreciated at the same persistent rate over the same period. The result has been disastrous for retired people living on a fixed income after retirement, they have no way of increasing their income. A man on a salary gets wages, but a retired man cannot compensate for rising prices in this way. This failure to cope with inflation has been one of the weaknesses of conventional fixed dollar retirement annuities offered by life insurance companies.

### THE RISING STANDARD OF LIVING

Moreover, the retired man does not want to settle for the stratum of his standard of living at the precise moment of his retirement. We are living in a dynamic economy where the work efficiency on a man-hour basis is constantly improving. This enables the public, in general, to enjoy a rising standard of living. The man who retires wants to share in this economic growth. However, if his retirement income precisely meets his needs at the time of retirement, this goal cannot be achieved. Only with a life annuity that has a tendency to rise with the rising standard of living can this goal be met. One of the objectives of the variable annuity is to enable the retired man to meet this goal.

### IMPROVED MONEY STORAGE FACILITIES

Even more fundamental, however, the variable annuity was designed to correct one other weakness of the typical conventional fixed dollar annuity. In many foreign countries, life insurance companies have as much as 25%, and in one country 35%, of their assets invested in common stocks. In the United States, the proportion is about 4%. The difference results partly from the different historical development in the United States and partly from the legal structure created in this country for the regulation of life insurance companies. No attempt will be made here to go beyond the mere statement of fact that it has been impractical for life insurance companies to invest a substantial part of an annuitants money being set aside for his retirement in equities, such as common stocks.[9] This has meant that if he has a fixed dollar annuity, most of his money has been invested in debt-type securities, such as bonds and mortgages. These are very fine investments to support fixed dollar annuities, and today the interest rate is abnormally high, but there are certain weaknesses. Only through an investment in equities can an annuitant participate in the growing dynamic economy of the United States.

The easiest concept to follow is to think in terms of the net overall investment return as one would think of an interest rate. However, the investment return in this case can be negative as well as positive. It would be negative if there was a depreciation in the value of the assets greater than the amount of the dividends received. For this reason, companies often use what they call a "net investment factor" which operates mathematically just like a

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[9] *See* G. JOHNSON & D. GRUBBS, THE VARIABLE ANNUITY (1967).

compound interest factor. The value of the net investment factor can be determined daily, weekly or monthly but most frequently it is now determined weekly.

It is customary in establishing the rate for annuities for life insurance companies to assume that some interest rate will be earned on the money. For example, this might be 4% or 5% a year. Similarly, in a variable annuity an assumed interest rate is used with the mortality table. Let us assume, for example, that precisely the same mortality table is used by a life insurance company for fixed dollar annuities and variable annuities, and that the interest rate assumption is 5% compounded annually. In such a case the dollar amount of the first monthly annuity payment will be precisely the same under both the fixed annuity contract and the variable annuity contract—assuming the same net purchase payment and the same age and sex for the annuitant.

Thereafter, the amount payable under the variable annuity would remain level only if the actual net investment return from the separate account remained at a constant level equivalent to an interest return of 5% compounded annually. Of course, this is not expected to happen. The investment factor will be either more or less than 5% and the amount of annuity payments will vary accordingly.[10]

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[10] In order to give some indication of how such variations might work the following table shows the theoretical amount of the variable annuity which would be provided, assuming a net investment rate of 5% per year and the investment performance for the separate account equivalent to that of the Massachusetts Investors Growth Stock Fund. This mutual fund was selected for this illustration because it had a record reaching back over 25 years. Other mutual funds might have been selected with a more dramatic "go-go" investment performance, especially companies with relatively recent investment experience operating with smaller funds.

Theoretical Amounts of Variable Annuity payments—Assuming an initial Annual Annuity of $1,000, a 5% annual interest factor is used with the Mortality Table, and Investment results are those of Massachusetts Investors Growth Stock Fund.

| | | Annual Variable Annuity Payments— If Annuity Payments were started on: | | | |
|---|---|---|---|---|---|
| Year | Av. Ann. Net Invest. Factor | 1/1/43 | 1/1/48 | 1/1/53 | 1/1/58 |
| 1943 | 1.206 | $ 1,000 | | | |
| 1944 | 1.184 | 1,206 | | | |
| 1945 | 1.342 | 1,427 | | | |
| 1946 | .877 | 1,916 | | | |
| 1947 | .980 | 1,680 | | | |

The deferred (retirement) annuities sold by life insurance companies provide a means of storing up during your working years a sum of capital which can be converted into a life annuity when you retire. These contracts can be purchased either in a single sum or with a series of payments. The conventional contract in the past has provided for the payment of a fixed level number of dollars.

## A HIGH INVESTMENT RETURN

Studies of past performance since the turn of the century show that the average investment return from common stock investment in any program conducted over a long period of time has been higher than the average return on bond and mortgage investments. The key word here is "time." Thus, a common stock investment program started thirty years ago is likely to have produced a return averaging 10% or more per year when the capital appreciations and the reinvestment and accumulation of all dividends are taken into account. In certain years however, the fund would have shown wide fluctuations.

When one thinks of a common stock investment he is likely to think of a personal investment in a particuular stock at a particular point in time which is dependent upon the performance of one company and one industry. One may also be forced to sell that stock at a time when stock market prices are low. Such investing can be highly speculative. These speculative elements, however, are

| | | | | | |
|---|---|---|---|---|---|
| 1948 | .957 | 1,646 | $1,000 | | |
| 1949 | 1,133 | 1,576 | 957 | | |
| 1950 | 1.278 | 1,785 | 1,084 | | |
| 1951 | 1.211 | 2,282 | 1,385 | | |
| 1952 | 1.001 | 2,763 | 1,678 | | |
| 1953 | .917 | 2,766 | 1,679 | $1,000 | |
| 1954 | 1.504 | 2,536 | 1,540 | 917 | |
| 1955 | 1.188 | 3,815 | 2,316 | 1,379 | |
| 1956 | 1.136 | 4,532 | 2,752 | 1,638 | |
| 1957 | .825 | 5,149 | 3,126 | 1,861 | |
| 1958 | 1.442 | 4,247 | 2,579 | 1,535 | $1,000 |
| 1959 | 1.105 | 6,125 | 3,719 | 2,214 | 1,442 |
| 1960 | 1.034 | 6,768 | 4,110 | 2,446 | 1,593 |
| 1961 | 1.203 | 6,998 | 4,249 | 2,530 | 1,647 |
| 1962 | .776 | 8,419 | 5,112 | 3,043 | 1,982 |
| 1963 | 1.135 | 6,533 | 3,967 | 2,361 | 1,538 |
| 1964 | 1.049 | 7,415 | 4,503 | 2,680 | 1,745 |
| 1965 | 1.200 | 7,779 | 4,723 | 2,811 | 1,831 |
| 1966 | .965 | 9,334 | 5,668 | 3,374 | 2,197 |
| 1967 | 1.240 | 9,008 | 5,469 | 3,256 | 2,120 |
| 1968 | | 11,170 | 6,782 | 4,037 | 2,629 |

greatly minimized where the investing is done over a long period of time by a life insurance company operating through what it calls a "separate account" comprised exclusively of common stocks.

The insurance company will usually follow a program set forth in a statement of investment policy which has been carefully designed and published. No stocks will be purchased with borrowed money. Investment risk will be spread by holding common stocks in a wide range of companies carefully selected by experts who think these companies have good future prospects. The risk will be further spread by picking companies in different industries selected for their growth potential. The portfolio will be selected and administered through common stock specialists who have been picked for their ability and skill.

The investor benefits from a process called "dollar cost averaging." Under a retirement annuity contract the purchaser buys the contract through a series of approximately equal payments spread over a long period of time. Such a program will result in buying more shares when the prices are low and less when the prices are high and will result in an average cost which is below the average of the prices. Most importantly, this spread of purchases over time greatly reduces the random chance risk that a large part of the stocks will be purchased at an unusually high point in the market.

Such a program provides diversification over time, over companies, over industries, and has a tendency to reduce the risk factors. These methods do not eliminate all of the risks, they merely reduce them. The objective is to have a good average experience, not to make the investor a prince at the risk of making him a pauper.

## HOW A VARIABLE ANNUITY WORKS

When a variable annuity is purchased, whether with a single sum or by a series of payments, and whether a deferred or an immediate annuity is purchased, the company first deducts a certain amount often referred to as the "load" to cover expenses and contingencies. The balance, the net payment, is then transferred to a "separate account." The Securities and Exchange Commission considers that such a separate account is, in essence, an investment company.[11]

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[11] *See*, S.E.C. v. Variable Annuity Co. 359 U.S. 65 (1959); S.E.C. v. United Benefit Life Ins. Co. 359 F.2d 619 (D.C. Cir. 1966); Prudential Ins. Co. of Am. v. S.E.C. 326 F.2d 383 (3d Cir. 1964), *cert. denied* 387 U.S. 210 (1967); Spellacy v. Am. Life Ins. Co. 144 Conn. 346, 131 A.2d 834 (1957).

Although the annuitant's rights are based on contract, not on property law, it is easiest for an attorney to think of the "separate account" as being like a common law trust. It is a commingled account with all parts being fungible. The common denominator is generally called an "accumulation unit." Such a unit is usually established at a figure set, say at one dollar, when the separate account starts. Thereafter, the unit will have a unit value. This unit value will always be equal to the current market value of the separate account on the date of the valuation divided by the number of accumulation units then outstanding. When the net payment is transferred to the separate account the annuitant is credited with a certain number of accumulation units.

Where valuations are weekly, for example, the new value of the accumulation unit can be determined in either of two ways, and one way can be checked against the other. Either the total net assets of the separate account can be divided by the number of outstanding accumulation units, or the value of an individual accumulation unit one week earlier can be multiplied by the net investment factor for the week.

When annuity payments begin, say at age 65, a different "unit" must be used. Most variable annuity plans provided by insurance companies make the same type of a "guarantee of mortality" as in the fixed dollar annuity. This means that the total amount of annuity payments to be received will not vary up or down because of any variation in the mortality experience of the persons having variable annuity contracts from the rate assumed when the annuity rates were established. Thus, the sole factor determining the variation in the amount of the annuity payments is the investment experience of the separate account which is invested in common stocks.

Let us assume for instance that the net payment amounted to $50 and the then current value of an accumulation unit was $2 per unit. The annuitant would be credited with 25 accumulation units. Obviously the value of the accumulation units from that point on is affected by the total overall investment return of the separate account, including capital appreciation and depreciation as well as the debit dividend income. All dividends are reinvested. This is of course the deferred (retirement) annuity contract. In this case there is an opportunity to accumuulate the money over very long periods of time at very high *average* interest rates without any part of the build-up being taxed to the individual annuitant in the meantime.

Let us look at a few specific examples. A wealthy man and his wife determine in a given year that they have already passed a sufficient amount of their estate to their children—they think that from an estate tax standpoint they should take full advantage of the tax provisions permitting them to pass along a certain sum each year to 13 grandchildren. They, therefore, purchase 13 deferred (retirement) annuity contracts with a single purchase payment of $6,000 each, for a total of $78,000. This fits within the provisions of the Internal Revenue Code permitting the deduction of $6,000 a year without paying any gift tax, or even affecting their lifetime gift tax exemption. Let us assume that the "load" is 8½% and that the average annual investment return is 8% or 10% a year.

In case it is thought that an average annual investment return of 10% a year is high, consider the following: The first variable annuity company was the College Retirement Equity Fund started in 1952 for college teachers. This company now has assets invested in equities exceeding $1,000,000,000. The average annual investment return for this company has been approximately 10% a year for 15 years. Also, the Wisconsin State Teachers Retirement Plan has had a variable annuity for eleven years and has had an average annual investment return of 12.6% a year.

One of the best indexes measuring common stocks investment performance is the Standard and Poor's Composite Index which has been maintained for a large group of stocks (including most of those actively traded on the New York Stock Exchange) since 1938. The average annual investment return for this group of stocks as indicated by this index has been approximately 10% per year since 1938. The Merrill, Lynch, Pierce, Fenner and Smith Foundation has conducted one of the most comprehensive studies of common stock experience at the University of Chicago. This included an industry diversification among all of the stocks on the New York Stock Exchange. The study shows that for the period January 1926 to December 1960, the average annual investment return was 9%, for the period of December 1950 to December 1960, the average rate was 14.8%. During the past seven years the average for this group of stocks has undoubtedly exceeded 10%.

So, while the 10% investment return factor is only an assumption, it is not wholly unrealistic.

Now to observe the effects of such high rates: If one of the grandchildren, Joey, was three years old when a deferred (retirement) variable annuity contract was taken out, and we assume the value of the contract is accumulated. At 8% and 10% a year respectively, the results would be as follows:

| When Joey Is Age | If the Annual Investment Return Is 8%* | 10%* |
|---|---|---|
| 3 | $ 5,490 | $ 5,490 |
| 21 | 21,900 | 30,000 |
| 35 | 74,700 | 132,000 |
| 45 | 139,000 | 300,000 |
| 55 | 300,000 | 770,000 |
| 65 | 647,000 | 2,000,000 |

* All figures are approximate.

Of course, there is no *assurance* that these yields will be earned. Similarly, there is no assurance that the tax laws will remain the same, that Joey will live to age 65 or that the contract will be maintained for the entire period. But, in spite of these limitations, the attractiveness of such a contract is apparent. In fact, the potential return is so great that many people are skeptical. But, facts are facts, and should be investigated, not disregarded.

A good way to set up such a gift is to have a letter from the grandparents stating that they desire that this contract be maintained in force as a backlog of security for as long as is practical—but that Joey or his legal representatives during his minority shall have full discretion as to whether the contract should be maintained or surrended for cash.

Any attorney will readily see how such a variable annuity can be used in connection with a divorce settlement or in connection with a trust settlement as a means of funding an obligation to a child.

An attorney's income usually starts out low when he is young and does not reach its peak until late in life. His problem is to struggle through the early years until the fatter ones begin to arrive. Often though for certain people the pattern is reversed. Some people get too much too soon. Their income hits a high point very early in life but with every chance of declining later on.

Child stars of screen, stage, radio and TV have this problem. Professional athletes, pilots, some young authors, and others earn big money while still young. But the big money may not last. It is important that they store up some of this excess income for later use.

Purchasing a variable annuity is an ideal way to store it up. For one thing a variable annuity will actually yield a periodic income—not a lump sum of cash to cause more worries—at any selected date in the future. That income, moreover, is guaranteed to continue for life.

Even more important is the inflation resistance built into the contracts. In cases such as these, it may be 40 or 50 years before all of the income is to be collected. By that time a dollar may buy only a fraction of what it buys today. Moreover, our standard of living may have increased so much that a larger income is needed and desired to maintain an acceptable standard of living at that time. A variable annuity can offer some hope that these goals will be reached.

There is still another advantage. In the years between the purchase payment and the income payment, the purchase money paid to the life insurance company can grow and multiply in the life insurance company's "separate reserve account" through both dividends and appreciation. Yet none of this increase is taxed to the purchaser all of this time—at the time when income may still be relatively large and tax brackets high. Income taxes will be paid later but the owner will probably then be in a lower tax bracket.

For example, Johnny K is 10 years old and for the past year has been getting around $1,000 a week for his role in a movie and TV series. His parents believe he has two or three more years of continued success. After that, who knows? They, therefore, purchase for him a $10,000 single purchase deferred (retirement) variable annuity, specifying that income is to start when he is 65 years old. Thus, they will store up for him some of the purchasing power he does not need now but may need badly then. At 65 Johnny K's annuity would be extremely large if the investment return in the future is anywhere near what it has been in the past. Meanwhile, if he ever needs to start to receive an income or if he needs cash before he is 65, he has the option to do so.

Sam L. is a young man whose name, face and earned-run average are familiar to every student of the sports page. At 25 he is among the best of today's major league pitchers. His salary is officially a secret, but the columnists place it at around $50,000. He may stay that high, or go higher for several years, but Sam knows well that his big money days are numbered. Within 10 or 15 years and possibly sooner his salary will almost surely start to decline. To protect himself against this thinner time, he may buy a variable annuity. He may plan to put in $2,000 a year for a 10 year period.

One of the best uses of the variable annuity, in conjunction with a fixed dollar annuity, is as a means of settling an estate for a young divorcee. In almost any divorce settlement, the wife's attorney will try hard to get his client an assurance of income that will be independent of her former husband's future earnings. This is not always easy. If practical, the attorney usually prefers to have a trust fund set up for that purpose. But when the amount involved ranges—say from $20,000 to $50,000—a trust may not be practical. A variable annuity can often serve as an effective substitute.

Dorothy L. is 40 and in the process of obtaining a divorce from her husband. She has two children, a girl 5 years of age and a boy 4 years of age. The husband is the owner of a successful import-export firm. Her attorney, mindful of the hazards of Mr. L's business, argues for and gets a settlement in the form of a $35,000 single purchase (payment) immediate variable life annuity with annuity payments guaranteed for 20 years and for her remaining lifetime.[12] Or the money might be spent evenly to buy a fixed and a variable annuity. This will add about $1,500 the first year to Mrs. L's alimony and personal resources. During the next 25 years it may well yield an amount of income that averages much more.[13]

The parents of children, or relatives of people who are handicapped, mentally retarded or otherwise incompetent, have real cause for concern. It is their desire to provide lifetime support for their charges and the support must continue even if they themselves should die or suffer financial reverses. The income and its source must be beyond the reaches of creditors or speculators. It shouuld to the greatest extent be safe from inflationary erosion, and if

[12] The income is of course guaranteed for Mrs. L's lifetime, but because she has custody of the two young children, she does not want to risk a possibility of the income being cut off should she die before they are on their own. She, therefore, elects an Option which provides that the payments will be guaranteed for 20 years, whether she lives that long or not; thus, the children are also protected.

[13] The following figures show the income that would be received if the investment results coincide with those of the past 25 years of the Massachusetts Investment Growth Stock Fund and the original contract had an assumed interest rate of 5% per annum.

| Year | Annuity | Year | Annuity |
|---|---|---|---|
| 1943 | $ 1,500 | 1956 | 6,799 |
| 1944 | 1,809 | 1957 | 7,723 |
| 1945 | 2,144 | 1958 | 6,366 |
| 1946 | 2,874 | 1959 | 9,188 |
| 1947 | 2,521 | 1960 | 10,153 |
| 1948 | 2,470 | 1961 | 10,498 |
| 1949 | 2,364 | 1962 | 12,629 |
| 1950 | 2,678 | 1963 | 9,800 |
| 1951 | 3,423 | 1964 | 11,123 |
| 1952 | 3,545 | 1965 | 11,668 |
| 1953 | 4,150 | 1966 | 13,002 |
| 1954 | 3,805 | 1967 | 13,512 |
| 1955 | 5,723 | 1968 | 16,755 |

possible, it should be forthcoming with a minimum amount of management and red tape.

The variable annuity is the solution. Let us look at one actual sale. The parents were sure that they would be be able to look after their retarded child as long as they lived. They had a large amount of life insurance, but they were concerned about the future of the child after a number of years. The parents saw the variable annuity as offering them some hope of building up an adequate estate for the child over a period of about 30 years. In this case, the parents did not have sufficient funds to buy the contract at one time with a lump sum payment; so a series of purchase payments was made amounting to $50 a month.

When a man's estate consists chiefly of his insurance proceeds, his widow may be unsure what to do. If she leaves all of the proceeds with an insurance company to be paid in the form of a conventional life annuity, she is committed to living on a fixed number of dollars for the rest of her life and the long-range inflationary trend plus the rising standard of living may make that fixed income wholly inadequate. Yet if she takes the proceeds in a lump sum to invest in common stocks with growth stock capabilities, she surrenders the automatic income and is also at the mercy of her investment advisors and salesman who may have more zeal than skill. She may, therefore, decide to diversify. She leaves half of the proceeds with the insurance company to be paid as a fixed dollar life income. With the balance she buys an immediate variable life annuity.[14]

Of course, the same considerations would apply when a person receives a large sum from any source, such as the maturing of an endowment contract or a bond purchased many years in the past.

[14] The following table shows the actual amount of immediate variable life annuity received by the participants in the College Retirement Equity Fund who started getting these variable annuities in 1953. Her initial (first monthly) payment from a fixed dollar annuity and a variable annuity will be approximately the same:

| Year | Annuity | Year | Annuity |
|---|---|---|---|
| 1953 | $10,000 | 1961 | 27,563 |
| 1954 | 11,577 | 1962 | 27,436 |
| 1955 | 14,815 | 1963 | 23,814 |
| 1956 | 19,435 | 1964 | 27,804 |
| 1957 | 17,724 | 1965 | 29,825 |
| 1958 | 17,545 | 1966 | 31,951 |
| 1959 | 23,031 | 1967 | 33,516 |
| 1960 | 23,511 | | |

An almost identical situation is produced by a "windfall," a sudden and perhaps unexpected sum of money that is not needed for current expenses. It may come from an inheritance or from a lucky business venture. The problem is to store up the purchasing power now and withdraw the purchasing power as a life income later on. The variable annuity fits this situation well.

Men in later life, say age 65, who find themselves in the high income tax brackets and high estate tax brackets, can make effective use of variable annuities in two ways.

First, they can purchase immediate annuities on their own lives. If they take a sizeable sum of money and invest it in stocks or bonds, the income produced is drastically reduced by income taxes. Moreover, they get no use from the invested capital itself, instead the capital adds to the estate-tax burden at death.

An outstanding attorney at age 74 bought a sizeable variable immediate straight life annuity for this purpose. He managed to convert a large part of the balance of his estate into life annuities. He had given away his home retaining a life estate in it. When he died, eight years later, his federal estate tax was cut to a minimum. While he was receiving the life annuity payments, only a fraction of the income was taxable.

One of the best ways to take advantage of the annual gift tax exemption ($3,000 for each individual if single, $6,000 if married) is to buy a variable annuity for each heir. The heirs are thus provided with a property producing a lifetime income—yet the purchase money will not pass through the estate and be eroded by death taxes and the subsequent income, as the property is growing, will not be taxable to the heirs.

## CONCLUSION

Many of the special situations referred to above apply equally to fixed dollar annuities and variable annuities. Never has the fixed dollar annuity been as good a buy as it is today—with the high interest rates being credited by life insurance companies. The variable life annuity is truly a new and exciting financial tool. It must also be remembered that often a combination of the fixed and variable annuities will best meet a particular situation. Every attorney should understand when and how to use such annuities.